AP Microeconomics
Test: Efficiency, Equity, and the Role of Government

Instructor's Version

Answers: Free-Response Questions

1. A market failure is defined as a socially undesirable outcome of a market free of government intervention. Describe each of the following market failures, including a definition and an example. Then provide the government intervention commonly used to solve that market failure. Describe the social costs of the market failure and the social benefits of government intervention. (24 points)

In general terms, we are looking at 8 points per question, divided in the following manner:
2 for definition,
1 for example,
1 for recognizing the social cost,
2 for government intervention, and
2 for describing the social benefit of government intervention.

A. Negative externalities

2 for definition: *A negative externality is a cost imposed on a third party to an action that the decision-maker didn't take into account when choosing the action.*
1 for example: *anything is fine.*
1 for recognizing the social cost: *there are gains to be made if the decision-maker takes into account the externality.*
2 for government intervention: *by clearly defining property rights and making transactions easier, the government can eliminate many externalities; for example, laws that limit the decibel level of car stereos assigns ownership of relatively quiet air to the rest of the population.* ***Examples are fine here.***
2 for describing the social benefit of government intervention: *With government intervention, the decision-maker will no longer impose costs on others — legal restrictions may prevent the activity that harmed others.*

B. Public goods

2 for definition: *A public good has two characteristics — the use of the good by one person doesn't diminish the amount available to anyone else, and people cannot be excluded from using the good.*
1 for example: *anything is fine.*
1 for recognizing the social cost: *a public good will not be offered for sale by a private firm, since a private firm cannot exclude free-riders.*
2 for government intervention: *by providing public goods free of charge to everyone, then collecting taxes, the government avoids the free-rider problem and supplies a good that wouldn't be supplied by the free market.*
2 for describing the social benefit of government intervention: *government supplies goods that wouldn't be supplied by the free market; if these goods are valued by society, then government provision of these goods is a social benefit*

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C. Imperfect information

> ***2 for definition:*** *information is costly, and buyers and sellers do not always have access to information*
> ***1 for example:*** *nearly anything is fine, from the accuracy of weights and scales in the grocery store, to the qualifications of doctors, to the reliability of used cars.*
> ***1 for recognizing the social cost:*** *when costly information is kept hidden, transactions that might have benefited people in society don't take place.*
> ***2 for government intervention:*** *the government can intervene by creating standards, providing information, regulating parties in a transaction, etc.*
> ***2 for describing the social benefit of government intervention****: the intervention allows transactions to occur that wouldn't necessarily have otherwise occurred, at least not without significant information costs to one or both of the parties to the transaction, and these transactions make people better off.*

2. The distribution of income is a topic that includes many positive and normative elements of economic analysis. Provide both normative and positive arguments in favor of each of the following tools of income redistribution. In your argument, be sure to define each of the tools of redistribution and be careful to mark your arguments as normative or positive. (21 points)

> *In general terms each part is worth 7 points divided in the following way:*
> *3 for definition,*
> *2 for positive argument in favor, and*
> *2 for normative argument in favor.*
> *Take off two points if they consistently switch positive and normative.*

A. Transfer payments

> ***3 for definition:*** *these are payments made to people based on a criteria established by law; often called entitlements, they include things like social security benefits, welfare, unemployment benefits, etc.*
> ***2 for positive argument in favor:*** *by providing people with income and other benefits when they "need" it, it is more likely that they will return to being productive members of society.*
> ***2 for normative argument in favor:*** *the government has an obligation to provide for those members of society who cannot provide for themselves.*

B. Minimum wage legislation

> ***3 for definition:*** *minimum wage laws require that certain types of employees be paid a legal minimum wage per hour.*
> ***2 for positive argument in favor:*** *minimum wage laws provide higher income to the employees who are able to find and keep employment at the minimum wage.*
> ***2 for normative argument in favor:*** *the government has an obligation to transfer funds from those who have money, such as business owners and consumers, to those who have less, the low-skilled low-income workers.*

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C. Progressive national income tax

3 for definition: *higher income taxpayers pay a higher proportion of their income in taxes* ***(take off 2 points if they just say that higher incomes pay higher taxes since this is also true for proportionate and some regressive taxes)***
2 for positive argument in favor: *national income tax places the burden of the tax more heavily on those who earn higher incomes, and perhaps are more able to bear the burden of the tax.*
2 for normative argument in favor: *those who earn higher incomes should bear more of the tax burden, since they can afford it; people who earn more income ought to help support those who are less able to earn income, and they can do this by bearing more of the tax burden.*

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